

Reflections on Convenience Translations: A Reply to Professor Brooks

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The staff of the Securities and Exchange Commission has a de facto requirement that the consolidated income statements of foreign companies registering under the Securities Act of 1933 be presented not only in their domicile currency but in American dollars for the convenience of the American investor. The author uses valuation theory to demonstrate that these convenience translations serve no useful purpose.

In the January 1980 issue of *The Business Lawyer*, Professor Roy L. Brooks published an excellent article, entitled *Currency Translations in the Registration Statements of Foreign Issuers*.¹ The article describes Guide 24 of the Guides for Preparation and Filing of Registration Statements,² as interpreted by SEC staff accounting bulletins number one³ and number eight,⁴ which de facto require that the consolidated income statements of foreign companies registering under the Securities Act of 1933 be presented not only in their domicile currency but in American dollars for the convenience of the American reader.⁵

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1. Brooks, *Currency Translations in the Registration Statements of Foreign Issuers*, 35 BUS. LAW. 435 (1980).

2. Securities Act of 1933 Release No. 4936, 67-69, FED. SEC. L. REP. (CCH) ¶ 77,636 (Dec. 9, 1968).

3. See [1977] 6 FED. SEC. L. REP. (CCH) ¶ 74,001 (1977).

4. See [1977] 6 FED. SEC. L. REP. (CCH) ¶ 74,008 (1977).

5. Brooks, *supra* note 1, at 437-38. For a general discussion of the burden of American securities regulations on foreign issuers, see Note, *Neutralizing the Reg-*

An SEC registration statement for a foreign issuer generally must contain income statements for the five most recent years.⁶ Professor Brooks describes five alternative methods of translating into dollars a foreign issuer's income statements for the last five years.⁷

The first two methods use a *single* exchange rate to convert *all* figures. Method One uses the exchange rate existing at the most recent balance sheet date. This approach is currently a de facto requirement of the SEC.⁸ In Method Two, the single rate used is an average of either (a) all exchange rates during the five year period or (b) all exchange rates during the last year only. Method Three applies different exchange rates to each of the five years. In other words, each year is translated separately. The rate used for each year is an average of all exchange rates during that year. Methods Four and Five involve partial or total elimination of convenience translations. Method Four foregoes any currency translations except for the last year's figures, which could be converted either at the end-of-year rate or a composite average of all rates during the year. Method Five involves abandoning currency translations entirely.

In summary, the five alternative approaches are:

Method One: a single extremely recent rate (current SEC approach)

Method Two: a single rate, which is the average of rates for either the entire period or the last year only

Method Three: separate rates for each year, with each separate rate determined by the average of all rates for that year

Method Four: translations for the last year only

Method Five: no translations

Professor Brooks concludes that, to the extent one is committed to a policy of convenience translations, Method One is better than Method Three, but that Method Four is the best of all.

The purpose of this article is to demonstrate the uselessness of

ulatory Burden: The Use of Equity Securities by Foreign Corporate Acquirers, 89 YALE L.J. 1413, 1419-22 (1980) [hereinafter cited as Note, *Foreign Acquirers*] and sources cited therein.

6. See Form S-1, Item 6(a), reprinted in 6A R. SHAPIRO, A. SACHS & C. OLANDER, SECURITIES REGULATION FORMS, PRACTICE-COMPLIANCE app. 1-4, 7 (1979); [1976] 1 SEC. REG. GUIDE (P-H) ¶ 4501; [1976] 2 FED. SEC. L. REP. (CCH) ¶ 8145. See generally sources cited in Brooks, *supra* note 1, at 443 n.67.

For a general discussion of the current SEC policy on foreign issuers and the SEC filing requirements imposed on foreign issuers, see Note, *Foreign Acquirers*, *supra* note 5, at 1433-35.

7. Brooks, *supra* note 1, at 447-51.

8. [1977] 6 FED. SEC. L. REP. (CCH) ¶ 74,101, quoted in Brooks, *supra* note 1, at 437 n.17.

a convenience translation policy. My position is based upon an analysis of the process by which an American investor would value a foreign security.

THE VALUE OF A FOREIGN SECURITY TO AN AMERICAN INVESTOR

A sophisticated American investor will evaluate a Japanese security, for example, by discounting to present value the dollar-equivalents of all future payments. Two analogies may be helpful. Suppose there is a primitive society which produces just chickens and pigs and has a barter system. Mr. Shapiro is one of the residents. All he has in the world is one hundred chickens. Mr. Shapiro is kosher and never eats pigs. Another resident, Mr. Fuji, owns a pig farm, which he offers to sell to Mr. Shapiro in exchange for all one hundred of Mr. Shapiro's chickens. The value of the pig farm to Mr. Shapiro is based on two *completely separate* factors: (1) the number of pigs the farm will produce in the future (which might be extrapolated from past production), and (2) the future exchange or barter ratios of pigs to chickens (which might be extrapolated from past exchange ratios). These two factors will determine the number of chickens Mr. Shapiro will be able to eat.

Chickens are comparable to dollars. Pigs are like yen. Mr. Shapiro is analogous to an American investor. Mr. Fuji is like a Japanese issuer. The pig farm is comparable to a security.

To an American investor, a foreign issuer could also be analogized to a hypothetical American silver mining firm, the "Index Mining Company." This corporation somehow manages to pay in silver all of its costs of operation and expansion. In other words, the third parties with whom the firm deals are willing to make long-term commitments to be paid in only slightly varying amounts of silver. The company pays all interest and dividends in silver.

Because this hypothetical mining company's costs are effectively "indexed" to the price of silver, the net income of the corporation is far less volatile than that of an actual domestic silver mine. Nevertheless, the *dollar* return to the Index Mining Company's security holders still depends on two factors: (1) the future dividend, interest, and/or principal payments *in silver*, and (2) the dollar price of silver. To value a security of the Index Mining Company, one would have to (1) predict future payments on

the security, (2) multiply by the anticipated silver price at the time of payment, and (3) discount to present value using a risk-adjusted interest rate.⁹ To predict future payments on the security, the investor may wish to project future silver production. This may in turn be based partly on an extrapolation of past silver production.

To the American investor, the common stock or yen bonds of a Japanese issuer are similar to the securities of the Index Mining Company. Most of the costs of the Japanese firm will be denominated in yen and will not be directly affected by the conversion rate between yen and dollars. In order to value the Japanese securities, however, the American investor will have to engage in a multi-step process: (1) predict future yen payments on the securities, (2) project future exchange rates at the time of the payments, (3) convert the yen payments into dollars, and (4) discount these projected dollar payments to present value using a risk-adjusted discount rate.¹⁰ The projections described in steps one and two are separate and independent because they deal with different variables.

9. For a general discussion of discounting future returns to present value, see V. BRUDNEY & M. CHIRELSTEIN, *CASES AND MATERIALS ON CORPORATE FINANCE* 35-78, 429-32 (2d ed. 1979); J. COX, *FINANCIAL INFORMATION, ACCOUNTING, AND THE LAW: CASES AND MATERIALS* 147-63 (1980); R. HAGIN, *MODERN PORTFOLIO THEORY* 243-46 (1979); J. LORIE & M. HAMILTON, *THE STOCK MARKET—THEORIES AND EVIDENCE* 113-24 (1973); R. POSNER, *ECONOMIC ANALYSIS OF THE LAW* 315-21 (2d ed. 1977); J. VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 14-43 (4th ed. 1977); J. WESTON & E. BRIGHAM, *MANAGERIAL FINANCE* 249-82, 341-452, 639-52 (6th ed. 1978). See also H. KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 25 (1979); Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1197 (1970).

10. See note 9 *supra*.

For a number of reasons, a depreciation of a foreign issuer's domicile currency (against the dollar) may be associated with an increase in the foreign issuer's earnings. See R. RODRIGUEZ & E. CARTER, *INTERNATIONAL FINANCIAL MANAGEMENT* 235-39 (2d ed. 1979). Therefore, the dollar-equivalents of future payments on a foreign security conceivably may not be that volatile.

Actually, by diversifying between securities of different nations, the volatility of the American investor's total portfolio might decrease. This complicates the adjustment of the discount rate for risk. For a discussion of international diversification, see R. RODRIGUEZ & E. CARTER, *INTERNATIONAL FINANCIAL MANAGEMENT* 483-86 (2d ed. 1979) and sources cited therein at 498-500; T. COPELAND & J. WESTON, *FINANCIAL THEORY AND CORPORATE POLICY* 500-03 (1979).

For a general discussion of portfolio risk, see V. BRUDNEY & M. CHIRELSTEIN, *supra* note 9, at 1144-55; T. COPELAND & J. WESTON, *FINANCIAL THEORY AND CORPORATE POLICY* 153-56 (1979); J. COX, *supra* note 9, at 164-70; R. HAGIN, *supra* note 9, at 95-197; J. LORIE & M. HAMILTON, *supra* note 9, at 171-97; R. POZEN, *FINANCIAL INSTITUTIONS: CASES, MATERIALS AND PROBLEMS ON INVESTMENT MANAGEMENT* 139-46, 158-61 (1978); J. VAN HORNE, *supra* note 9, at 45-73; J. WESTON & E. BRIGHAM, *supra* note 9, at 350-58; Cohen, *The Suitability Rule and Economic Theory*, 80 YALE L.J. 1604, 1607-14 (1971); Note, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach*, 88 YALE L.J. 1238, 1239-41 (1979), and sources cited therein. See also H. KRIPKE, *supra* note 9, at 26, 89-93.

In order to predict future yen payments on the securities, the American investor may wish to project future corporate net income in *yen*. This latter projection may in turn be based partly on an extrapolation from past *yen* sales, profits, and earnings.¹¹

Of course, the American investor may eventually sell the security. The sale price in dollars can be regarded as the final "payment" on the security, although not made by the issuer. This anticipated final "payment" should also be discounted to present value, along with all other future payments.

If a security sold in the United States is also traded in Japan, the future market value of the security may be determined mostly by Japanese investors. The value of the security to a "typical" Japanese may be different from its value to a "typical" American. The Japanese investor engages in a two-step valuation process: (1) predict future yen payments on the security, and (2) discount these projected yen payments to present value using a risk-adjusted discount rate.¹² In other words, the Japanese would skip the second and third steps of the American investor's four-step valuation process.

Furthermore, "typical" Japanese and American investors might use different risk-adjusted discount rates. Among the reasons are the following. First, the risk-free (government bond) interest rates in the two nations probably would not be the same. Second, because of fluctuating exchange rates, the American's dollar returns may be more volatile than the Japanese's yen returns. Third, the addition of a Japanese security to the American investor's portfolio of mostly American securities would have a different effect on total portfolio risk than the addition of a Japanese security to the Japanese investor's mostly Japanese portfolio. Diversification between nations may decrease total portfolio risk.¹³

Because the Japanese and American valuation processes are different, and because the Japanese market forces may be determinative, in order to calculate the present dollar value of a Japanese security's eventual resale price, an American investor must predict the yen value of the security to the typical Japanese in-

11. See Brooks, *supra* note 1, at 446-47. But see H. KRIPKE, *supra* note 9, at 99 (suggesting that future earnings cannot be extrapolated from past earnings). Accord, R. HAGIN, *supra* note 9, at 52-55; B. MALKIEL, *THE INFLATION-BEATER'S INVESTMENT GUIDE* 56 (1980).

12. See generally sources cited note 9 *supra*.

13. See note 10 *supra*.

vestor¹⁴ at the moment that the American eventually will resell. That yen value converted into dollars at the then prevailing exchange rate will be the dollar resale price of the security. In other words, the American investor must anticipate the conversion rate at the time he will sell the security.

THE USELESSNESS OF CONVENIENCE TRANSLATIONS

Clearly, the American investor must predict future exchange rates when determining the present dollar value of the security of a foreign issuer. Nevertheless, the Securities and Exchange Commission's mandated convenience translations are of little use. As mentioned earlier, when valuing a Japanese security, an American may use the corporation's past yen income statements to project future corporate net income in yen and future yen returns on the security. These future returns would then be converted to dollars at anticipated future exchange rates. The projections of future yen returns and future exchange rates are two *distinct* processes. Thus, there is no need to convert past yen income statements into dollars. Even if an investor perversely insisted on "mixing apples and oranges" by converting past yen corporate income statements to dollars, he would convert only certain "bot-

14. Lord Keynes once compared stock market speculation to entering a newspaper beauty-judging contest in which the prize goes to the person whose six selections out of 100 photographs most nearly conform to those of the group as a whole. A sophisticated player chooses the faces that the other entrants are likely to fancy. (A super-sophisticated contestant chooses the faces that other players will think other entrants will select, and so on.) J. KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY* 156 (1936). See also W. BAUMOL, *THE STOCK MARKET AND ECONOMIC EFFICIENCY* 38 (1965); B. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 23-24 (1973); B. MALKIEL, *THE INFLATION-BEATER'S INVESTMENT GUIDE* 24 (1980).

When calculating the present value of the securities of domestic issuers, financial theorists reject Keynes' views and instead assume that the market is rational and that buyers value securities using a discounting process. Therefore, the eventual resale price of a security will be the discounted value of future payments on the security at the time of resale. In other words, the new buyer will discount future payments to present value and assume that his buyer in turn will do the same. Therefore, resale prices can be disregarded and the present value of a domestic security is simply the present value of all future payments by the issuer. Simplifying somewhat, the value of a security to someone who resells is the same as the value to him if he held it forever. V. BRUDNEY & M. CHIRELSTEIN, *supra* note 9, at 429-32; T. COPELAND & J. WESTON, *supra* note 10, at 18-20; J. VAN HORNE, *supra* note 9, at 19-23; J. WESTON & E. BRIGHAM, *supra* note 9, at 639-43.

This may not be true when an American investor buys a foreign security. Because the Japanese and American valuation processes are different, an American investor who values a Japanese security cannot ignore the resale price problem. The security's value is the sum of (1) the present value to the American of all payments by the issuer while he holds the security, and (2) the present value of the resale price. The latter is equal to the value of future payments to a Japanese at the time of resale. An American investor buying a Japanese security must anticipate the results of a future rational Japanese "beauty contest" using a discount rate possibly different from his.

tom lines," such as net income.¹⁵

CONCLUSION

When a foreign security is valued, future returns (in the domicile currency) and future exchange rates are projected separately. Therefore, past corporate income statements need not be converted into American dollars. The Securities and Exchange Commission should not mandate any convenience translations, and certainly not translations of each line of a foreign issuer's consolidated income statements for the past five years.

The Commission might more profitably encourage foreign issuers to include a separate chart showing the exchange rates at the end of each of the last five fiscal years.¹⁶ This information would assist the American investor to project future exchange rates. Such a table would also enable the American investor to convert certain "bottom lines" of the foreign issuer's income statements, if he erroneously insisted on mixing two disparate phenomena.

The current Securities and Exchange Commission staff's de facto requirement of convenience translations is an example of misplaced paternalism. Translations of past income statements of foreign issuers are worse than useless; they misleadingly combine two separate trends.¹⁷ To borrow a maxim from another culture, when it comes to "convenience" translations, less is more.

15. Past net income can be viewed by debtholders as the past cushion against default and by shareholders as the past amount which theoretically could be paid as dividends. For a general discussion of dividends and capital budgeting, see V. BRUDNEY & M. CHIRELSTEIN, *supra* note 9, at 429-50; T. COPELAND & J. WESTON, *supra* note 10, at 327-49; J. VAN HORNE, *supra* note 9, at 277-96; J. WESTON & E. BRIGHAM, *supra* note 9, at 789-818.

In the case of foreign issuers, the dollar equivalents of past corporate net income are not useful in predicting future net income because the dollar figures mix two separate and important trends—changes in the exchange rate and changes in net income in the domicile currency.

16. Professor Brooks' article mentions the somewhat similar approach of instructing the American reader to translate each statement of the five-year period at a single rate set forth at the beginning of the prospectus in prominent type. Brooks, *supra* note 1, at 450 & n.129.

17. Eliminating such counter-productive regulatory burdens would also serve the worthwhile purpose of facilitating international capital mobility and thereby improving the world allocation of resources. See Note, *Foreign Acquirers*, *supra* note 5, at 1425. See generally *id.* at 1422-26.

